Papers claim there is national bias in ECB interest rate decisions

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in Berlin

Doubts have been cast on the credibility of the central bank's position on decision making

WHEN THE European Central Bank hiked its main interest rate in April, then president Jean-Claude Trichet denied the move aided "core" euro zone states like Germany at the expense of Ireland and other "periphery" countries.

Battling hay fever and a sceptical press pack, Mr Trichet insisted the ECB governing council's decision adhered to the bank's price stability mandate and was "directly and indirectly of benefit to all 331 million citizens in the single currency area".

"We do what we have to do even when it is difficult and not necessarily pleasing to everyone. That's our job," he said.

Two new academic studies in Germany question that claim, with which the ECB justifies all its decisions. The papers claim to have found evidence of national bias over interest rate decisions, not to mention a greater influence than presumed of larger members.

Just how the ECB governing council sets its key interest rate is one of the best-kept secrets of the finance world. Unlike the US Federal Reserve, which publishes minutes of its decision-making meetings, the Frankfurt bank swathes in mystery decisions made in the 36th floor conference room at the ECB tower.

This is in the interests of all, the bank says, in particular to prevent national bank governors on the governing council coming under pressure from their home countries.

But rising euro zone pressures, particularly the recent resignations of Bundesbank president Axel Weber and of chief economist Jürgen Stark over the bond-buying programme, have exposed like never before tensions in the governing council.

These brief clearings in the mist have revealed what was generally supposed: that each Frankfurt consensus is hard-fought.

The first of the two papers, "Behind closed doors: Revealing the ECB's Decision Rule", compares actual interest rate decisions to the so-called "Taylor rule". This monetary policy rule stipulates how much the central bank should change the nominal interest rate in response to changes in inflation, output, or other economic conditions. At the heart of the rule is the "Taylor Principle", which stipulates that each one point increase in inflation should result in a nominal interest rate rise of more than one percentage point.

The researchers, Bernd Hayo and Pierre-Guillaume Méon, ran their comparison through various theoretical permutations of ECB council influence to see which one came closest to actual European Overnight Average Index (Eonia).

"The scenario that performs best is the one in which individual members of the governing council follow national objectives and bargain over interest-rate setting based on weights derived from their country's share in the euro area's GDP," write the authors. "This scenario produces a mean interest rate closest to the average of Eonia, with the lowest standard deviation around that mean."

Interest rate decisions made by bargaining over interest rates performed better, they found, than scenarios presuming a consensus- or rule-based voting system.

"Actual behaviour does not match that mandated in the ECB statutes, which stipulates that the governing council should make its decisions using a simple majority vote," the authors continue. "The finding also throws some doubt on the credibility of the ECB's official position that all its decisions are based on consensus."

The authors say the ECB claim that decisions meet the needs of the euro zone as a whole is undermined by findings suggesting the governing council consists, "at least partly, of members pursuing national objectives".

The second paper, published by Munich's Ifo economic institute, looks at the role played by nationality at the ECB and suggests that "national networks" operating in the bank's management appear to be linked to monetary policy decisions. The researchers ran two Taylor rule analyses – one weighted to economic size, the other weighted to national representation in ECB management – and compared them to the actual interest-rate decisions.

Researchers Harald Badinger and Volker Nitsch say they found "convincing evidence" that the analysis taking national representation into account was a closer fit to actual interest rate decisions than that factoring economic weight. "What the ECB does is clearly closer to national weighting for nationality, without being able to say that specific countries are treated preferentially," said Prof Volker Nitsch of the Technical University Darmstadt.

A protester holds a placard reading "banks behind barriers" in front of the ECB

Prof Nitsch says their study, "National Representation in Multinational Institutions: The Case of the European Central Bank", looks at ECB management rather than the governing council and is not aimed at spurring on conspiracy theorists about ECB decision-making.

However, critics of the ECB are likely to seize their study as evidence of national prejudice – in particular EU staff hiring fellow countrymen – being cemented in the bank's core areas: finance market operations, economy, finance stability and research.

The ECB declined to respond to requests for comment on the two papers, which have prompted a lively reaction in Germany. At the presentation of the Badinger-Nitsch paper, the *Frankfurter Allgemeine* daily said that "jaws dropped" at their findings.

But other economists have warned against extrapolating firm conclusions from the studies.

"I don't have a problem with what they're doing – it's quite clever – but the findings, particularly the national bias conclusions are not very persuasive," said Prof John McHale, head of economics at NUI Galway, saying there are many ways of interpreting the two studies' findings.